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SUBJECT: PUSHING THE ENVELOPE: ESTONIA TRIES TO SPUR INNOVATION

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¶1. (U) SUMMARY: Estonia's relatively lean and dynamic economy can still make progress in a number of areas towards spurring greater innovation and productivity gains. Both will be necessary to meet labor shortages and move the economy up the value chain to a position where it can move out of competition with lower-wage markets to be on par with EU-15 economies. The GOE is trying to re-start a series of strategic efforts to meet Lisbon Agenda goals by 2014, primarily by supporting more research and development in ICT, bio- and nanotechnologies. Its plans to do so, while detailed, are largely on paper so far. Real change may ultimately come only in the areas where market forces make it inevitable. Post will look for opportunities to support this important goal. END SUMMARY.

Strong in some areas, stagnant in others...
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¶2. (U) Estonia is a well-know leader in the IT sector, and sits at the forefront of e-commerce and e-government, with nationwide wi-fi as well as Europe's highest level of internet usage and the first-ever instance of online voting in a national election. The country has gotten substantial mileage out of its role in developing the internet telephony giant, Skype, and its pro-business, free-market tax and investment policies. However, with a tight labor market and rapidly rising wages (20 percent growth in 2006), there is significant pressure on the economy to increase productivity through innovation and new technologies. (Note: Unemployment in Estonia was 4.2 percent as of Q3 2007, and lower in the capital, as compared to the EU27 average of 8.2 percent for 2006. End Note) Prime Minister Andrus Ansip and numerous business leaders have frequently cited potential gains in productivity and innovation as ways to address the labor shortage issue (reftel). Innovative new procedures, in particular, would allow the economy to continue growing without the politically unpalatable measure of importing large numbers of workers from Russia or other non-EU countries, something that all leaders of the country have said is not a viable option. Estonia's December 23 accession to the EU's Schengen visa area may alleviate some of this problem, by eliminating the need for foreign workers to obtain a separate Estonian visa. Additionally, politicians see innovation as key to shifting Estonia's economic footing from a manufacturing and lower value-added basis to one of higher-end services and information technology. Estonia recognizes that with wage levels now at 65 percent of those in the older EU member states, it is no longer competitive with China and India in electronics assembly, textiles, and other manufacturing jobs even after accounting for its geographic proximity to the EU market. (Note: The International Labor Organization's 2006 Key Indicators in the Labor Market ranked Estonian labor productivity ahead of Germany and Switzerland, and at 67 percent of the U.S. level. End Note)

Among New EU Members: In the Middle of the Pack
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¶3. (U) Estonia's standing with respect to other EU Member States on innovation performance was evaluated in the 2006 European Innovation Scoreboard (EIS). While Estonia ranked relatively well against the nine other new Member States, it fell into the 'Trailing' category overall, ranked below the Czech Republic and Slovenia among other new members. Of the five broad areas of innovation performance measured, Estonia did best on "Innovation and Entrepreneurship," leading the EU in expenditures per capita on Information and Communications Technology (ICT). Estonia was ranked third best in the EU in its support for Tertiary Education as one of the "Innovation Drivers." Weak points were on "Applications" such as sales of new-to-market products and high-tech exports, reflecting comments we have heard locally that recent innovations in Estonian business have been more "process" innovations in the service sector than "product" innovations in manufacturing.

¶4. (U) Another major deficiency cited in the 2006 EIS was in the area of intellectual property (IP). The number of Estonia's new patents, trademarks and designs lagged far behind the older EU states, but roughly in the middle among its peer group the ten new members that joined in 2004. The Estonian Patent Office announced July 9th that applications during the first half of the year for the international registration of trademarks and patents were both higher than for the same period in 2006. Nevertheless, some GOE contacts speculate that the overall poor showing in the IP category may reflect licensing agreements which ultimately give the credit for research done by Estonian subsidiaries to their foreign parent companies, instead of to Estonia.

A Plan for Action, or just a Plan?



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¶5. (SBU) The Ministry of Economic Affairs and Communication (MOE) coordinates the GOE's efforts to set thematic priorities and create a supportive environment for innovation. In a conversation with Econoff, MOE's Technology and Innovation Policy Division chief, Marika Popp, explained the challenges ahead, and the Ministry's strategy for addressing them. Over the next six years, 2007-2013, Estonia will receive more than EEK 53 billion (USD 4.5 billion) in EU structural funds. It will be difficult to absorb these funds fully without more expertise and capacity in the sciences and engineering, as well as R&D. In order to use this money in ways that both improve infrastructure and enhance the economy's competitiveness, Estonia will need to attract outside scientists and specialists in a range of fields and increase domestic spending on R&D. By their own estimation, the GOE does not expect to meet the Lisbon Agenda goal of 3 percent of GDP spent on R&D by 2010, but rather by 2014. (Note: In 2005, the level was 0.94 percent of GDP, which was double the 2001 level. Private sector investment in R&D was another 0.42 percent of GDP and is growing quickly. End Note.)

¶6. (SBU) MOE's Popp acknowledged that the government's first national innovation strategy, "Knowledge Based Estonia 2002-2006," lacked focus. The new plan is focused on the three key areas of ICT, biotechnologies, and materials sciences; it also aims to nearly double the 2004 number of workers in R&D by 2014. While both MOE and the Ministry of Education and Research are considering measures to attract the necessary workers and specialists to Estonia, MOE's Popp admitted that "We have not yet outlined [this program's] terms and conditions to such a detailed extent." However, a working group comprising the Ministries of Economy, Interior, Education and Foreign Affairs, as well as representatives from labor and management, proposed changes to the GOE which are expected to be passed into law soon (by mid-2008). These changes would double the number of skilled workers that could be admitted to the country, cut the wait time by half for their visas, and ease restrictions on low-skilled

workers - perhaps even those from Russia and Ukraine.

¶7. (SBU) While the GOE's new innovation strategy, "Knowledge Based Estonia 2007-2013" certainly seems focused on getting results, and the GOE placed innovation in its new Coalition Agreement priorities in April, some observers we spoke to have their doubts. Marje Josing, Director of the Estonian Institute of Economic Research, noted that the GOE has been urging the private sector for years to move up the production value chain and pursue innovations that would reduce dependency on labor and increase productivity and competitiveness. The plans, strategies and incentives are all well and good, but in the end it is market forces and external pressures that are forcing companies to make the hard adjustments, she noted. Two cases of external pressure are the 1998 financial crisis in Russia and the 2004 "double tariffs" which Russia imposed after Estonia joined the EU, both of which forced Estonian firms to re-orient themselves away from the Russian market and towards the EU and other Western markets. Furthermore, the current convergence of Estonian wages and production input costs with those of the EU will likely be another market-driven incentive to force companies to become more productive.

Venture Capital to the Rescue?
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¶8. (SBU) Dr. Erik Terk of the private think tank, the Estonian Institute for Future Studies, feels the GOE needs to do a better job of coordinating the efforts of its ministries, citing Finland as a positive role model in this regard. Dr. Terk is on the board of one such effort, the new Estonian Development Fund. This fund, established by Parliament in 2006, capitalized by the GOE with EEK 620 million ($53.7 million USD), and launched in April 2007, was modelled on a Finnish example, "Sitra". The Fund aims "... to stimulate and support positive changes in the Estonian economy, contributing to modernization ... growth of exports, and creation of new jobs requiring high qualification. The Development Fund supports ... innovation, emergence of innovative business ideas and the growth of entrepreneurship in the whole society." While ICT and biotech are two of the stated priorities of the Ministry of Economy, the head of MOE's lead investment promotion agency, Enterprise Estonia, recently told us that his priorities are bringing more tourism, manufacturing, shipping and banking to the country (reftel). With Enterprise Estonia apparently focused on older, mainline industries, perhaps the new Estonian Development Fund or other private sources will seek out and identify innovative firms and individuals in the hi-tech economy.

¶9. (SBU) Comment: While there is no doubt that the Estonian



business and investment climate fosters innovation and entrepreneurship, the economy still faces serious challenges. Gaps in the labor force may make it difficult - if not impossible - for Estonia to absorb expected EU structural funds. Without a real commitment by the GOE to provide more than just plans on paper, Estonia will not be able to attract specialists in the fields of ICT, bio- and nanotechnology where the GOE wants to excel. That would be a shame because Estonia is otherwise well-positioned to continue the remarkable transformation of its economy seen in recent years. Post has been active sending Estonian officials for IP training to the U.S., but we will look for other areas where we can support MOE's goals through exchange programs, training, and sharing of expertise. End Comment.

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